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INSIDER TRADING FLAW: TOWARD A FRAUD-ON-THE-MARKET THEORY AND BEYOND

KENNETH R. DAVIS*

No federal law specifically makes insider trading unlawful. Current law is based on section 10(b) of the Securities Exchange Act, the general antifraud provision. The deception giving rise to a trading violation under section 10(b) is a breach of fiduciary duty to the source of the information. This approach is misguided because the source of the information is not injured by the trade. Rather, the counterparty to the trade is injured, and, in a more general sense, confidence in the securities markets suffers as a result of trading on material, nonpublic information. Even worse, current law does not clearly prohibit the use of inside information in circumstances that no sensible law would condone. For example, suppose a thief steals corporate inside information and trades on that information. It is unclear whether the thief has violated section 10(b). Similarly, if a corporate insider provides material, nonpublic information to a friend and the friend trades on the information, it is unclear whether either party has violated the law. This Article proposes replacing the current regime with fraud-on-the-market theory based on the well-recognized duty to publicly disclose inside information or abstain from trading. A breach of that duty would be a fraud on the public and the counterparty, and would therefore violate section 10(b). The Article goes on to analyze and critique congressional bills that propose new insider trading legislation.

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INTRODUCTION

Since its inception, the law of insider trading has perplexed the legal community.[1] Scholars have criticized the law for its lack of clarity and over-complexity.[2] Such criticisms are understandable. Insider trading law is a dysfunctional hodge-podge of rules that make little intuitive sense. The problem arises in part because no U.S. statute defines insider trading. Rather, the United States Supreme Court, with minimal congressional guidance, has seized on the general antifraud provision in the Securities Exchange Act of 1934[3] to construct an incoherent legal regime. Section 10(b) of the Act makes it unlawful to use "any manipulative or deceptive device" "in connection with the purchase or sale of any security."[4] The Supreme Court has used this broad injunction as the starting point to fabricate a confusing brand of insider trading law. In a series of decisions, the Supreme Court's "common law" of insider trading disregards common sense.[5]

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1. This Article refers to all circumstances under which a party trades on material, nonpublic information as "insider trading." This term includes what is often referred to as "outsider trading." *See, e.g.*, Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 884 (2010) (explaining that the term "outsider trading" is frequently used to describe trading by a non-insider possessing material, nonpublic information).

2. *See, e.g.*, Homer Kripke, *Manne's Insider Trading Thesis and Other Failures of Conservative Economics*, 4 CATO J. 945, 949 (1985) (calling federal insider trading law "unconstitutionally vague"); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 379 (1999) (calling the misappropriation theory of insider trading a "theoretical mess"); Thomas Swigert & Milo Marsden, *Insider Trading: The Supreme Court Takes Another Look*, DORSEY (Feb. 5, 2016), https://www.dorsey.com/newsresources/publications/client-alerts/2016/02/insider-trading–supreme-court-takes-another-look (commenting that insider trading law is "notoriously murky"). *But see* Peter J. Henning, *What's So Bad About Insider Trading Law?*, 70 BUS. LAW. 751, 775 (2015) (arguing that insider trading law, though imperfect, "works fairly well as a legal doctrine").

3. 15 U.S.C. §§ 78a–78pp (2012).

4. *Id.* § 78j(b) ("It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange[:] . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement[,] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.").

5. *See* United States v. O'Hagan, 521 U.S. 642, 647 (1997) (adopting the misappropriation theory of liability); Dirks v. SEC, 463 U.S. 646, 654–64 (1983) (establishing the contours of tipper/tippee liability); Chiarella v. United States, 445 U.S. 222, 231–35 (1980) (adopting the classical or traditional theory of liability and finding no duty to disclose for a non-corporate insider who had no confidential information).

The fundamental problem with current insider trading law is that the Supreme Court has defined a "manipulative or deceptive device" as a breach of a fiduciary duty or confidentiality to the source of the inside information.[6] A breach of such a duty, however, has little, if anything, to do with what one would consider wrongful trading on material, nonpublic information. The trade is a wrong that is distinct from the breach of such a duty. Furthermore, the source of the inside information suffered no loss resulting from a trade made with inside information. The person with inside information deceived the counterparty who alone suffered financial injury.[7] The law should therefore focus on a breach of the duty, established in *In re Cady, Roberts & Co.*,[8] to disclose publicly the material information, thereby making it available to everyone, including the counterparty to the trade.[9]

Another fault of insider trading law is that in a tipper/tippee scenario, liability arises only when the original tipper derived a benefit from the original tippee.[10] This requirement, which the Supreme Court adopted in *Dirks v. SEC*,[11] is extraneous to the wrong that insider trading law seeks to redress. When a tippee knowingly trades on material, nonpublic information, liability should not depend on whether the tipper received a benefit for the information. Furthermore, the Supreme Court's discussion of this requirement has engendered a split among the circuit courts.[12] The issue is whether the requisite benefit to the tipper must be direct, such as a financial or reputational benefit, or whether the benefit may be indirect—that is, whether simply providing the inside information to a relative or friend constitutes such a benefit.[13] The United States Court of

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6. *Chiarella*, 445 U.S. at 229–30. This Article uses the term "inside information" to mean material, nonpublic information.

7. *See infra* Section II.B (explaining that the focus should not be on the method used to obtain the information and that the harm done is not borne by the source or owner of the information).

8. 40 S.E.C. 907 (1961).

9. *Id.* at 911.

10. *Dirks*, 463 U.S. at 659 (prohibiting the exploitation of inside information when the insider derives a personal gain from the use of the information).

11. 463 U.S. 646 (1983).

12. *Compare* United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014) (holding that providing inside information to a relative or friend does not meet the personal benefit requirement of *Dirks*), *with* United States v. Salman, 792 F.3d 1087, 1093 (9th Cir. 2015) (holding that providing the inside information to a relative or friend does meet the personal benefit requirement of *Dirks*), *cert. granted*, 136 S. Ct. 899 (2016).

13. *Salman*, 792 F.3d at 1092. The Supreme Court limited the issue on appeal to whether a tip to a relative or friend constitutes a benefit sufficient to meet the requirement of *Dirks*. 136 S. Ct. at 899.

Appeals for the Second Circuit held in *United States v. Newman*[14] that a concrete benefit—either financial or reputational—is required,[15] while the Ninth Circuit held in *United States v. Salman*[16] that the duty prescribed in *Dirks* is met when the tipper passes the information to a relative or friend.[17] This schism between the Second and Ninth Circuits has spawned inconsistency in the law that federal courts apply in insider trading cases.[18] Given this confusion, the Securities and Exchange Commission (SEC), with mixed success, has urged courts to apply the *Salman* standard.[19] To resolve this issue, the Supreme Court has granted a petition for a writ of certiorari in the *Salman* case.[20] Regardless of how the Supreme Court rules, insider trading law will remain focused on the wrong issues.

One promising approach to resolving the contradictions of insider trading law is to adopt a fraud-on-the-market theory. The application of this theory would be based on the *Cady, Roberts* duty to publicly disclose inside information. This approach would continue to use section 10(b) as the operative provision. Though having the virtue of conceptual clarity, this theory would reach only those cases where the trade occurred in a market efficient at disseminating material information. Because most insider trading cases involve securities traded on efficient markets, such as the New York Stock Exchange (NYSE) or NASDAQ, this limitation would not pose a serious impediment to establishing an effective law of insider trading.[21]

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14. 773 F.3d 438 (2d Cir. 2014).

15. *Id.* at 452.

16. 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 136 S. Ct. 899 (2016). On October 5, 2016, the Supreme Court heard oral arguments on the *Salman* case. Ben Protess & Matthew Goldstein, *What Is a 'Personal Benefit' from Insider Trading? Justices Hear Arguments*, N.Y. TIMES (Oct. 5., 2016), http://www.nytimes.com/2016/10/06/business/dealbook/supreme-court-insider-trading.html?_r=0.

17. *Id.* at 1093.

18. *Compare* United States v. Melvin, 143 F. Supp. 3d 1354, 1376 (N.D. Ga. 2015) (rejecting the *Newman* court's narrow interpretation of the *Dirks* benefit requirement), *with* SEC v. Holley, No. 11-0205, 2015 WL 5554788, at *4 (D.N.J. Sept. 21, 2015) (adopting *Newman*'s interpretation of *Dirks*), *and* SEC v. McGinnis, No. 5:14-cv-6, 2015 WL 5643186, at *18 (D. Vt. Sept. 23, 2015) (citing with approval the *Newman* court's interpretation of *Dirks*).

19. *See* Elaine Greenberg & Kevin Askew, *SEC Enforcement: 2015 in Review, and a Look Ahead*, 48 Sec. Reg. & L. Rep. (BNA) 586 (Mar. 21, 2016) (outlining two cases in which the SEC was unsuccessful in enforcement proceedings, but one case where it prevailed in a civil case after criminal charges were dismissed in light of *Newman*).

20. Salman v. United States, 136 S. Ct. 899 (2016).

21. Every case cited in this Article involved a trade on a well-recognized securities market where information was efficiently disseminated to the public.

Nevertheless, a complete solution to the problems of current insider trading law should come from Congress.[22] There has been progress. Representative Lynch has proposed a bill to redefine unlawful insider trading.[23] Representative Himes has proposed a bill calling for broader changes.[24] Senators Reed and Menendez have proposed a bill that would establish an even more expansive scope of liability than the two House proposals.[25]

These recent judicial and legislative developments present a fresh opportunity to reconsider the law of insider trading and to propose a new and more coherent framework. Part I of this Article analyzes the three existing theories of unlawful insider trading: the classical theory, the misappropriation theory, and tipper/tippee liability. Part I also contrasts the *Newman* and *Salman* decisions.

Part II exposes the flaws of the three theories discussed in Part I. As noted, the primary flaw in the classical and misappropriation theories is the focus on a breach of a fiduciary duty or confidentiality to the source of the information rather than a breach of the duty of disclosure owed to the counterparty to the trade. This Part also discusses the anomalous pre-condition to tipper/tippee liability that *Dirks* imposes; namely, that the tipper receives a benefit.

Part III explores how to improve insider trading law. First, this Part examines the presumption of reliance created in *Affiliated Ute Citizens v. United States*[26] and concludes that the *Affiliated Ute Citizens* presumption does not provide a satisfactory resolution. Next, this Part proposes extending fraud-on-the-market theory to insider trading cases. This extension of fraud-on-the-market theory would refocus insider trading liability under section 10(b) to a breach of the

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22. *See* Che Odom, *Congress Should Define 'Insider Trading': Ex-SEC Official*, 48 Sec. Reg. & L. Rep. (BNA) 405 (Feb. 24, 2016) (arguing that "[a] statute is needed to create some certainty in the law," and suggesting that "'[f]raud on the market' could be used as a baseline standard for such a statute"). The Supreme Court adopted fraud-on-the-market theory in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The Court stated that "[a]n investor who buys or sells stock at the market price does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247. The Supreme Court reaffirmed the vitality of fraud-on-the-market theory in *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2417 (2014). See *infra* Part III for a more detailed discussion of fraud-on-the-market theory.

23. Ban Insider Trading Act of 2015, H.R. 1173, 114th Cong. (2015).

24. Insider Trading Prohibition Act, H.R. 1625, 114th Cong. (2015).

25. Stop Illegal Insider Trading Act, S. 702, 114th Cong. (2015).

26. 406 U.S. 128 (1972).

Cady, Roberts duty of disclosure owed to the public and to the counterparty to the trade. Though conceptually coherent, this approach has the drawback of applying only to efficient markets. This drawback is relatively minor because most insider trading involves securities traded on such markets. Nevertheless, a new law is needed to provide a more comprehensive framework that would clarify and expand the boundaries of unlawful insider trading.

Part IV discusses and criticizes the three congressional proposals to redefine unlawful insider trading. This Part recommends broadening the scope of conduct prohibited under the Reed-Menendez proposal.

The Article concludes with a call to Congress to enact a much-needed law that would establish a simple, comprehensive, and sensible law of insider trading.

I. THE CURRENT STATE OF INSIDER TRADING LAW

Three theories of liability establish the prohibitions on insider trading law: (1) the classical or traditional theory, (2) misappropriation theory, and (3) tipper/tippee liability. This Part of the Article discusses and analyzes these three theories.

A. *The Classical Theory*

Section 10(b) of the Securities Exchange Act prohibits the use of "any manipulative or deceptive device" in connection with the purchase or sale of a security.[27] In *Chiarella v. United States*,[28] a landmark insider trading case, the Court interpreted the quoted language of section 10(b) to forbid a breach of fiduciary duty, rejecting the premise that section 10(b) imposes a general duty against trading on inside information.[29]

Chiarella was a printer working for Pandick Press, which printed documents announcing corporate takeover bids.[30] Though the names of the target companies did not appear on documents

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27. 15 U.S.C. § 78j(b) (2012).
28. 445 U.S. 222 (1980).
29. *Chiarella*, 445 U.S. at 231–32. The Court also relied on SEC Rule 10b-5. *Id.* at 225. That rule, which supplements section 10(b), makes it unlawful for any person to "employ any device, scheme, or artifice to defraud," or to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (2015).
30. *Id.* at 224.

provided to Chiarella, he was able to deduce the names.[31] He traded the stock of these companies, without disclosing the names of the targets publicly, and he ultimately profited more than $30,000.[32]

The issue in *Chiarella* was whether section 10(b) imposes a general prohibition against trading on material, nonpublic information.[33] The Court responded that "liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[34] The Court explained that "[a]pplication of the duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[35] The duty to disclose or abstain from trading, as first expressed in *Cady, Roberts*, however, extended only to those who have a fiduciary duty to corporate shareholders.[36] Thus, the duty did not apply to everyone in possession of inside information.[37] The Court justified this holding by noting that section 10(b) does "not [forbid] every instance of financial unfairness";[38] it prohibits only breaches of fiduciary duty. Chiarella had no fiduciary duty to the target companies—the companies whose stock he traded.[39] He had a relationship only with the acquiring company because Pandick Press worked for it.[40] Because Chiarella traded the stock of the target companies to which he owed no duty, he had not violated section 10(b).[41]

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31. *Id.*
32. *Id.*
33. *Id.* at 226.
34. *Id.* at 230.
35. *Id.*
36. *Id.* at 232.
37. *Id.*
38. *Id.* at 232, 234–35 ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.").
39. *Id.* at 232–33. Nor was Chiarella a corporate insider of the target companies. *Id.* at 231.
40. *Id.* at 232–33.
41. *Id.* Justice Stevens noted that an alternative theory of liability was arguable; namely, that Chiarella had violated a duty to Pandick Press, his employer. *Id.* at 238 (Stevens, J., concurring). Because the government had not argued this misappropriation theory, Justice Stevens concluded that the Court was correct in not addressing that issue. *Id.* Justice Brennan argued that, in addition to the classical theory, section 10(b) prohibited the misappropriation of insider information any

B. Misappropriation Theory

The *Chiarella* Court left open the issue of whether the misappropriation of confidential information, absent a fiduciary duty to shareholders, constituted a violation of section 10(b).[42] In *United States v. O'Hagan*,[43] the Court held that section 10(b) forbids such misappropriation.[44] Grand Met retained the law firm Dorsey & Whitney to represent it in its planned tender offer to acquire Pillsbury.[45] Anticipating the tender offer, O'Hagan, a partner of Dorsey & Whitney, bought Pillsbury shares and call options.[46] When Grand Met announced the tender offer, Pillsbury common stock vaulted from thirty-nine dollars to sixty dollars per share, and O'Hagan made a profit of more than $4.3 million.[47]

The Supreme Court in *O'Hagan* answered the question left open in *Chiarella*, recognizing the misappropriation theory as a basis of liability for insider trading.[48] The Court explained that a person engages in unlawful insider trading under section 10(b) by misappropriating "confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[49] Unlike the classical theory, which focuses on a fiduciary duty that a corporate insider owes to a company, the misappropriation theory premises liability on anyone who, entrusted with confidential information, trades on such information.[50] The rationale for liability under the misappropriation theory is that by

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time the source of the information expected the recipient to abstain from trading on it. *Id.* at 238–39 (Brennan, J., concurring). He found, however, that the jury instructions did not adequately charge misappropriation, and he therefore concurred in the judgment. *Id.* at 239. Chief Justice Burger not only believed that section 10(b) adopts the misappropriation theory of liability, but he also concluded that the government did argue the case on that basis; he therefore dissented. *Id.* at 243–45 (Burger, C.J., dissenting). Justice Blackmun, whom Justice Marshall joined, wrote a separate dissent in which he argued that section 10(b)'s prohibition against engaging in "manipulative" schemes applies to anyone who, with knowledge that material, nonpublic information has been kept confidential, trades on that information. *Id.* at 252 (Blackmun, J., dissenting).

42. *Id.* at 236 (majority opinion) ("We need not decide whether this [misappropriation] theory has merit for it was not submitted to the jury.").

43. 521 U.S. 642 (1997).

44. *Id.* at 647.

45. *Id.*

46. *Id.*

47. *Id.* at 648.

48. *Id.* at 665.

49. *Id.* at 652.

50. *Id.*

trading on confidential information, a person has deceived the source.[51] Such trading therefore constitutes "a deceptive device or contrivance," which is forbidden under section 10(b).[52]

From a policy point of view, the Court observed that the misappropriation theory promotes investor confidence.[53] Average investors would not be able to overcome the disadvantage they would face when competing with those trading on misappropriated information.[54] Allowing the trading of securities based on misappropriated information would therefore undermine investor confidence and would discourage potential investors from participating in capital markets.[55]

C. *Tipper/Tippee Liability*

Dirks v. SEC is the seminal case on insider trading involving a tipper and a tippee. As shown below, the elements of tipper/tippee liability remain controversial thirty years after the *Dirks* decision.

1. *The* Dirks *case*

Raymond Dirks was an officer of a broker-dealer that analyzed insurance company securities and provided the analyses to institutional investors.[56] Equity Funding was a company that sold life insurance and mutual fund shares to its customers.[57] Ronald Secrist, a former officer of Equity Funding, revealed to Dirks that Equity Funding had fraudulently overstated its assets, and he urged Dirks to disclose the fraud publicly.[58] Dirks investigated Secrist's charges and found that certain employees of Equity Funding corroborated Secrist's allegations of fraud.[59] Dirks discussed this information with many of his clients, including five investment advisors who liquidated more than $16 million of Equity Funding securities.[60] Dirks also revealed the fraud to William Blundell, a reporter for the *Wall Street Journal*, but Blundell, who feared a libel suit, declined to print a story

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51. *Id.*
52. *Id.* at 653.
53. *Id.* at 658–59 ("Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.").
54. *Id.*
55. *Id.* at 658.
56. Dirks v. SEC, 463 U.S. 646, 648 (1983).
57. *Id.* at 649.
58. *Id.* Neither Dirks nor his firm had a financial interest in Equity Funding. *Id.*
59. *Id.*
60. *Id.*

revealing Dirks's allegations.[61] In the meantime, Equity Funding stock plunged from twenty-six dollars to fifteen dollars per share, prompting the NYSE to halt trading of the stock.[62] The State of California then impounded Equity Funding's records, finding evidence of massive fraud.[63] Soon thereafter, the SEC filed a complaint against Equity Funding, and the *Wall Street Journal* published an article based largely on information that Dirks had provided.[64] Equity Funding went into receivership immediately after the SEC action and the news article.[65]

After an administrative law judge conducted a hearing into Dirks's involvement in the Equity Funding scandal, the SEC found that, by disclosing material, nonpublic information about Equity Funding to his clients, Dirks had aided and abetted violations of section 10(b) of the Securities Exchange Act and section 17(a) of the Securities Act of 1933.[66] The tippees, his clients, had committed primary violations of the acts because they (1) knew or should have known the information was confidential, (2) knew or should have known that the source of the information was a corporate insider, and (3) traded on the information.[67] Because the tippees met these three elements, they violated the *Cady, Roberts* duty to disclose the information publicly or to abstain from trading on it.[68] Despite finding that Dirks had aided and abetted securities law violations, the SEC merely censured him because he had helped reveal the fraud.[69] Nevertheless, Dirks appealed to the D.C. Circuit, which affirmed the SEC's decision.[70] The circuit court held that the recipients of nonpublic information inherit the fiduciary duties of corporate executives who provided the information.[71] The U.S. Supreme Court granted Dirks's petition for a writ of certiorari.[72]

61. *Id.* at 649–50.
62. *Id.* at 650.
63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.* at 650–51. Section 17(a) of the Securities Act of 1933 also prohibits the fraudulent sale of securities. 15 U.S.C. § 77q (2012).
67. *Dirks*, 463 U.S. at 650–51.
68. *Id.*
69. *Id.* at 651–52.
70. *Id.* at 652.
71. *Id.* (concluding that as an employee of a broker-dealer, Dirks also had violated independent obligations to the SEC and the public).
72. *Id.*

a. The majority decision

The Court began its analysis by reaffirming *Chiarella*, which held that there is no general duty to disclose material, nonpublic information.[73] A person, according to *Chiarella*, must have a fiduciary duty to the company to trigger section 10(b) liability.[74] Even given a fiduciary duty, the very language of section 10(b) forbids only those breaches that involve "manipulation or deception."[75] Such a "manipulation or deception," the Court believed, occurs when the insider trades on material, nonpublic information and reaps "secret profits."[76]

The *Dirks* Court recognized, however, that assigning liability to tippees requires an analytic step that the *Chiarella* Court did not make.[77] The question was whether, as the circuit court had held, a non-insider tippee automatically inherited the duty of an insider tipper and, if not, what elements must be met for tippee liability to arise.[78] In resolving this issue, the Court rejected the SEC's view that tippees inherit the fiduciary obligations of corporate insiders.[79] The fallacy in the SEC's reasoning, said the Court, stemmed from the mistaken belief that sections 10(b) and 17(a) require equal information to all market participants.[80] The Court observed that analysts, in the course of researching securities, often acquire material, nonpublic information and that the acquisition of such information is a necessary function of a vibrant securities market.[81]

To trigger liability, a corporate insider who acts as a tipper must exploit the information for personal gain, which may be financial or reputational.[82] The Court went further, noting that the relationship between the parties may imply personal gain for the tipper.[83] For example, providing material, nonpublic information to a relative or friend who trades on the information is unlawful because the insider

73. *Id.* at 654.

74. *Id.* at 654 (citing Chiarella v. United States, 445 U.S. 222, 227–35 (1980)).

75. *Id.* (citing Santa Fe Indus. v. Green, 430 U.S. 462, 472–73 (1977)).

76. *Id.* (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961)) (explaining that the secret profit stems from such deceptive behavior).

77. *Id.* at 655.

78. *Id.*

79. *Id.* The SEC argued that Dirks breached a duty when he knowingly received confidential information from insiders at Equity Funding, which placed him, and similar tippees, in the same position as insiders once he knowingly transmitted that information to a likely trader. *Id.* at 655–56.

80. *Id.* at 657.

81. *Id.* at 658–59.

82. *Id.* at 659, 663.

83. *Id.* at 664.

has effectively traded for himself and given the profits to the relative or friend.[84] Additionally, the Court stated that for a tippee to be liable for unlawful insider trading, the tippee must know or have reason to know that the tipper reaped such a gain.[85] If a tippee does not have reason to know that the tipper profited from the transaction, the actions of the tippee cannot be related back to the tipper's improper conduct and, therefore, the tippee has not violated section 10(b).[86]

Turning to the facts of the present case, the Court first noted that Dirks, an outsider to Equity Funding, owed no fiduciary duty to its shareholders.[87] Because he did not breach a duty when he passed the information to his clients, no liability attached as a result of those disclosures.[88] The Court then turned to the actions of Secrist, who received no personal benefit for providing the information about Equity Funding to Dirks.[89] Rather, Secrist's desire to expose the fraud motivated the disclosure.[90] Absent any personal gain on Secrist's part, no derivative liability arose against Dirks.[91]

b. The dissenting opinion

Justice Blackmun wrote a dissenting opinion in which Justices Brennan and Marshall joined.[92] Justice Blackmun observed that Secrist's intent in disclosing the fraud to Dirks was to trigger sales of Equity Funding stock by Dirks's clients and thus force the SEC to recognize the fraud.[93] According to Justice Blackmun, Secrist accomplished by proxy what the law forbade him to do directly.[94] Under these facts, Dirks committed unlawful insider trading.[95] Justice Blackmun argued cogently that the majority's analytic error

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84. *Id.* Whether tipping a relative or friend constitutes a benefit to the tipper is unsettled. *Compare* United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014) (holding that a tip to a relative or friend is not sufficient in itself to constitute a benefit to the tipper), *with* United States v. Salman, 792 F.3d 1087, 1092 (9th Cir. 2015) (holding that such a close personal relationship is sufficient), *cert. granted*, 136 S. Ct. 899 (2016).
85. *Dirks*, 463 U.S. at 660.
86. *Id.* at 661.
87. *Id.* at 665.
88. *Id.*
89. *Id.* at 666–67.
90. *Id.*
91. *Id.*
92. *Id.* at 667 (Blackmun, J., dissenting).
93. *Id.* at 669.
94. *Id.* at 671.
95. *Id.*

was holding that, for liability to arise, the insider must benefit from the disclosure.[96] The duty to abstain from trading on inside information does not depend on motives; rather, it seeks to avoid harm by prohibiting the trade.[97] An Equity Funding shareholder who bought stock from Dirks's clients was injured regardless of Secrist's motives in disclosing the information to Dirks.[98]

2. *The conflict between the* Newman *and* Salman *decisions*

Dirks seemed to have made clear that when a tipper provided inside information to a friend or relative who traded on the information, the tipper received a benefit sufficient to trigger liability. Despite the apparent clarity of this rule, the Second Circuit in *Newman* held otherwise.

a. *The* Newman *decision*

In *United States v. Newman*, the government alleged that insiders from Dell and NVIDIA disclosed to financial analysts the earnings of both companies before releasing the information to the public.[99] After extensive tipping chains, Newman and Chiasson, both portfolio managers, received the Dell and NVIDIA information, traded on it, and profited $4 million and $68 million respectively.[100]

Newman and Chiasson argued that they had not violated insider trading law because the original tippers did not receive a personal benefit.[101] The principal issue was whether providing inside information to a friend, absent acquiring a more tangible benefit from the friend making a trade on that information, met the *Dirks* benefit requirement.[102] The original tipper of the Dell information was Rob Ray, who passed the information to his friend, Sandy Goyal.[103] The Second Circuit noted that the two were not "close" friends, though they had known each other for years, having attended the same business school and having worked together at

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96. *Id.*

97. *Id.* at 674–75 (citing Mosser v. Darrow, 341 U.S. 267, 273 (1951)) (analogizing Secrist's conduct to that of a trustee who is liable for a breach of fiduciary duty to his or her beneficiaries regardless of fault and regardless of whether the trustee benefited from the breach of fiduciary duty, and thus arguing that the law should hold corporate fiduciaries to the same standard).

98. *Id.* at 671.

99. 773 F.3d 438, 443 (2d Cir. 2014).

100. *Id.*

101. *Id.* at 444 (arguing also that the evidence did not prove they knew the original tipper received a personal benefit).

102. *Id.* at 447.

103. *Id.* at 443.

Dell.[104] Hyung Lim, the original NVIDIA tipper, provided the information to Chris Choi, a family friend Lim met at church and with whom Lim occasionally socialized.[105] Yet, the Second Circuit dismissed the government's contention that these relationships met the personal benefit requirement of *Dirks*.[106] The court stated: "[W]e hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[107]

b. The Salman *decision*

In *United States v. Salman*, the Ninth Circuit, unlike the Second Circuit, held that providing inside information to a friend, even without acquiring a more tangible gain, may satisfy *Dirks*.[108] In *Salman*, Maher Kara, a healthcare investment banking employee at Citigroup, shared material, nonpublic information with his brother, Michael.[109] Maher became engaged to Salman's sister and, over the course of the engagement, Salman and Michael became close friends.[110] Michael then shared with Salman information he had received from Maher.[111] Rather than trading in his own brokerage account, Salman traded through the account of his wife's sister and her husband, Karim Bayyouk.[112] Salman and Bayyouk split the profits, which totaled approximately $1.7 million.[113] When Salman asked Michael who furnished the information, Michael revealed that Maher was the source.[114] The government proved at trial that (1) Maher and Michael had a close personal relationship, and (2) Salman knew the nature of that relationship.[115]

The principal issue in the case was whether the relationship between Maher and Michael was sufficient to meet the personal benefit prong of *Dirks*.[116] Salman urged the Ninth Circuit to adopt

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104. *Id.* at 452.
105. *Id.* at 443, 452.
106. *Id.* at 453.
107. *Id.* at 452.
108. 792 F.3d 1087, 1093 (9th Cir. 2015), *cert. granted*, 136 S. Ct. 899 (2016).
109. *Id.* at 1088–89.
110. *Id.* at 1089.
111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.*
115. *Id.* at 1089–90.
116. *Id.* at 1091.

the holding of *Newman*, which rejected the proposition that disclosing inside information to a trading relative or friend per se constitutes a personal benefit.[117] Rather, Salman urged that *Dirks* requires that when information is passed to a relative or friend, the tip must carry the potential of a financial or reputational benefit.[118] The Ninth Circuit held that, to the extent that Salman's reading of *Newman* was correct, such a holding was inconsistent with *Dirks*.[119] To dispel any doubt that its interpretation of *Dirks* was sound, the Ninth Circuit quoted *Dirks*, which stated: "The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend."[120] *Dirks*, according to the Ninth Circuit, required nothing more than the relationship.[121]

Salman filed a petition for a writ of certiorari.[122] One of the questions presented was whether a family relationship or friendship, standing alone, meets the personal benefit requirement of *Dirks*.[123] The Supreme Court granted the petition, limiting the appeal to that issue.[124]

Dirks appears to answer the question raised in *Salman*. The Supreme Court made clear that a personal relationship, whether arising from family or friendship, confers a benefit on the tipper.[125] The Second Circuit in *Newman* interpreted this language as "indicating that the tipper's gain need not be *immediately* pecuniary," but that "the personal benefit received in exchange for confidential information must be of some consequence."[126] This reading of *Dirks* seems

117. *Id.* at 1093.

118. *Id.*

119. *Id.* at 1093–94 (finding the Second Circuit's holding untenable and pointing out the absurd conclusion of Salman's theory that "a corporate insider or other person in possession of confidential and proprietary information would be free to disclose that information to her relatives, and they would be free to trade on it, provided only that she asked for no tangible compensation in return").

120. *See* Dirks v. SEC, 463 U.S. 646, 664 (1983); *Salman*, 792 F.3d at 1092–93 (noting that the *Newman* decision quoted that dispositive language, and suggesting that the Second Circuit effectively conceded its misinterpretation of *Dirks*).

121. *Salman*, 792 F.3d at 1093.

122. Petition for Writ of Certiorari, *Salman v. United States*, 136 S. Ct. 899 (2016) (No. 15-628).

123. *Id.* at 11.

124. *Salman*, 136 S. Ct. at 899.

125. *Dirks*, 463 U.S. at 664.

126. United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014); *see also* Petition for Writ of Certiorari, *supra* note 122, at 13 (quoting *Dirks*, 463 U.S. at 662) ("[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.").

doubtful. *Dirks* did not dwell on the intimacy of a relationship or the likelihood of future gains.[127] Tipping any relative or friend would seem, under *Dirks*, to constitute a personal benefit.[128] The same conclusion follows from a policy point of view. To allow a person with inside information to feed that information to a friend or relative would further tarnish an already discredited securities marketplace.[129]

Though the issue of whether tipping a relative or friend is an important one, *Salman* and *Newman* implicitly raise even more fundamental questions. For example, why is any benefit to the tippee required to establish unlawful insider trading under section 10(b)? Even more important is the central question: Are the classical, misappropriation, and tipper/tippee theories sensible applications of section 10(b)? Part II of this Article discusses these questions.

II. THE INCOHERENCE OF INSIDER TRADING LAW

Fashioned by a series of Supreme Court decisions, the regime establishing liability for insider trading is deeply flawed. As shown below, the major decisions—*Chiarella*, *O'Hagan*, and *Dirks*—are riddled with incoherence. If section 10(b) is the vehicle for establishing insider trading law, it must be applied in a wholly new manner.[130]

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127. Even so, sometimes the evidence shows a benefit meeting *Newman*'s restrictive standard. In *SEC v. Payton*, the jury found two former brokers liable for insider trading. 97 F. Supp. 3d 558 (S.D.N.Y. 2015). *See* Patricia Hurtado, *SEC Overcomes Tougher Insider Standards in Broker Suit*, 48 Sec. Reg. & L. Rep. (BNA) 459 (Feb. 29, 2016) (reporting that the SEC did not rely merely on a friendship to prove that the tipper received a benefit and that the original tipper received monetary benefits from his tippee including a reduction in rent).

128. *Compare* SEC v. Yun, 327 F.3d 1263, 1280 (11th Cir. 2003) (taking an expansive reading of the *Dirks* benefit requirement), SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995) (holding that providing inside information to a trading friend meets the *Dirks* benefit requirement), *and* United States v. Melvin, 143 F. Supp. 3d 1354, 1376 (N.D. Ga. 2015) (declining to follow the *Newman* court's interpretation of the *Dirks* benefit requirement), *with* SEC v. McGinnis, No. 5:14-cv-6, 2015 WL 5643186, at *18 (D. Vt. Sept 23, 2015) (stating that *Newman* made clear that a mere friendship, particularly if casual, does not meet the *Dirks* benefit requirement), *and* SEC v. Holley, No. 11-0205, 2015 WL 5554788, at *3–4 (D.N.J. Sept. 21, 2015) (following the *Newman* court's interpretation of the *Dirks* benefit requirement).

129. *See* Heidi Moore, *Wall Street and Washington Want You to Believe the Stock Market Isn't Rigged. Guess What? It Still Is*, GUARDIAN (June 22, 2014, 7:45 AM), https://www.theguardian.com/commentisfree/2014/jun/22/wall-street-washington-stock-market-rigged-investors (commenting on the erosion of investor confidence in the securities markets).

130. *See infra* Part III.

A. The Deficiencies of the Classical Theory

Section 10(b) makes it unlawful to use "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of a security.[131] The *Chiarella* Court held that when a corporate insider trades on material, nonpublic information, the insider has breached a duty to the company and its shareholders.[132] The insider has therefore engaged in a deception in connection with the purchase or sale of a security.[133] A breach of fiduciary duty has occurred because the insider has, without authorization, effectively converted corporate information and used it for his own profit.[134] By doing so, the corporate insider, similar to the unfaithful trustee, has violated the duty of loyalty and fairness to shareholders.[135] There is, however, a conceptual flaw in linking insider trading liability to a breach of fiduciary duty to the corporation and its shareholders. It is analytically suspect to make the wrong that gives rise to an insider trading violation something other than the trade itself.[136] In other words, the wrong should be the fraud perpetrated on the counterparty to the trade rather than an entirely separate wrong inflicted on the source of the information.

SEC v. Zandford,[137] however, seems to contradict the premise that the deception on the source of the inside information should be superfluous to an insider trading violation. *Zandford* was a securities fraud case rather than an insider trading case.[138] It is nevertheless relevant because *Zandford* held that, under appropriate circumstances, a broker who stole funds from his clients could be liable for securities fraud, though he did not commit a fraud about

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131. 15 U.S.C. § 78j(b) (2012).
132. Chiarella v. United States, 445 U.S. 222, 230 (1980).
133. *Id.*
134. *See* Carpenter v. United States, 484 U.S. 19, 26–27 (1987) (holding that a fraud can be perpetrated by depriving a business the exclusive use of its own confidential information).
135. *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 193 (1991) (arguing that, like a trustee, the insider has a duty of "utmost fairness" to the corporation and its shareholders (quoting GEORGE T. BOGERT, TRUSTS § 96, at 348 (6th ed. 1987))).
136. *See* Adam R. Nelson, Note, *Extending Outsider Trading Liability to Thieves*, 80 FORDHAM L. REV. 2157, 2187 (2012) (observing that "[r]equiring a breach of duty between the misappropriator and the source of the information is unrelated to the purpose of the prohibition: to protect investors and the integrity of the market").
137. 535 U.S. 813 (2002).
138. *Id.* at 815.

the securities themselves.[139] It might follow by analogy that in an insider trading case the fraud need not concern the trade.

The facts of the case are instructive. Charles Zandford, a securities broker, persuaded William Wood, an elderly man in poor health, to open a brokerage account for himself and his mentally infirm daughter.[140] The Woods entrusted $419,000 to Zandford, conferring on Zandford the authority to trade securities without prior approval.[141] Zandford then sold securities from the Woods' account and transferred all the proceeds to his own account.[142] Though admitting to the misappropriation of funds, Zandford argued that the theft was not "in connection with the purchase or sale of a security" because he neither misrepresented nor omitted any information about a security.[143] The securities transactions, he argued, were incidental to his scheme, which was to steal the Woods' funds.[144] The Supreme Court saw the issue differently, holding that Zandford's scheme was unitary; his plan from the beginning was to purchase securities for the Woods' account, liquidate the securities, and misappropriate the proceeds.[145] The fraud was therefore in connection with the purchase or sale of a security.[146]

At first glance, *Zandford* might seem to support the current law of insider trading. The deceptive device in *Zandford* was the theft of the proceeds from the sale of securities in the Woods' account; there was no fraud regarding the securities themselves. By analogy, under the current law of insider trading, the fraud is a breach of confidentiality on the source of the information; there is no fraud regarding the trade. There is, however, a critical distinction between the *Zandford* case and insider trading cases: in an insider trading case, the victim of the trade is the counterparty, whereas in *Zandford* the victims of the trades were Wood and his daughter. Thus, in *Zandford*, unlike current insider trading law, the injury was linked to the fraud.

Another distinction between *Zandford* and insider trading cases is that unlawful insider trading differs significantly from ordinary

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139. *Id.* at 820.
140. *Id.* at 815.
141. *Id.*
142. *Id.* at 815–16.
143. *Id.* at 820.
144. *Id.*
145. *Id.*
146. *Id.* at 820–21.

violations of section 10(b).[147] An insider trading violation requires more than fraud in connection with a purchase or sale of a security. It requires *the exploitation of material, nonpublic information* in connection with the purchase or sale of a security.[148] Because of this additional element, the deceit should connect directly to the insider's trade.

By focusing on a breach of fiduciary duty to the corporation and its shareholders, *Chiarella* ignores the real victim of the insider trade: the counterparty. Whatever injury the corporation and its shareholders suffer from an insider's breach of fiduciary duty, the injury is not the result of the insider's trade. The corporation and its shareholders would have suffered the same injury regardless of whether the insider ever traded on the information. By way of analogy, if a man steals a woman's purse, whether he sells the purse to a third party is irrelevant to her claim for relief.

1. The harm to the counterparty

The Supreme Court has unmoored what constitutes an insider trading violation from the trade itself and the harm the trade causes. The injuries the law should seek to prevent are the deception on the counterparty and the inevitable loss in investor confidence. Whether the counterparty actually suffers any injury at all, however, has been a controversial question.

The counterparty has the expectation that the system will not be rigged and that insiders will not use informational advantages;[149] however, not all informational advantages are unfair, and those who acquire and subsequently trade on inside information are not necessarily engaging in deceptive conduct. Participants in securities markets understand that traders operate with asymmetries of information. Parties conduct research and gather information hoping to gain an advantage.[150] As the Supreme Court has recognized, such asymmetries of information are inherent to healthy securities

147. *See* Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 440 (characterizing insider trading as a *sui generis* form of securities fraud).

148. United States v. Gansman, 657 F.3d 85, 92 (2d Cir. 2011).

149. *See* Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 2 (1982) (noting that ordinary traders feel that when their counterparties are armed with inside information, their counterparties are unjustly enriched).

150. *See* Dirks v. SEC, 463 U.S. 646, 657–58 (1983) (noting that imposing liability on all market participants who knowingly receive and trade on inside information "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market").

markets.[151] A general ban on insider trading would suppress market research and punish market participants who have the skill to independently discover material, nonpublic information.[152]

Exploiting informational advantages arising from positions of power and access, however, is unfair. Insider trading law should punish insiders who trade on such information or provide the information to tippees who trade on the information. For example, suppose Trader A, owning shares of Mega Corporation, sells his stock to Trader B, who has inside information that Mega will soon release a blockbuster quarterly earnings report far exceeding Wall Street projections. When the parties make the trade, Mega is fifty dollars per share. When Mega publicly discloses the information one week later, the stock soars to sixty dollars per share. Trader A would have made ten dollars per share if he had not sold his Mega stock to Trader B.

Suppose further that Trader A buys shares of Mega from Trader B, who has information that Mega will soon release a dismal quarterly earnings report and provide negative forward guidance. One week later, when Mega discloses the negative information, the stock plummets from fifty dollars per share to forty dollars per share. Again, Trader A has suffered a loss of ten dollars per share, which he would not have sustained had Trader B publicly disclosed the inside information.

In both cases, the counterparty suffered an injury, and the injury would have been averted if the insider had followed the disclose-or-abstain rule. In neither case, however, did the trade injure the source of the information.

2. *Counterarguments*

Some argue that insider trading does not injure the counterparty.[153] They point out that the counterparty decides to trade or not to trade irrespective of whatever action the insider takes.[154] Thus, in the first illustration above, Trader A decided to sell

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151. *See id.* (rejecting the premise that the antifraud provisions of federal securities law "require equal information among all traders").

152. *See* J. Kelly Strader, *(Re)Conceptualizing Insider Trading:* United States v. Newman *and the Intent to Defraud*, 80 BROOK. L. REV. 1419, 1424 (2015) (supporting the Supreme Court's inclusion of a duty element in insider trading law because such an element frees someone innocently possessing inside information from criminal culpability).

153. *See, e.g.*, Leo Katz, *The Problem with Consenting to Insider Trading*, 69 U. MIAMI L. REV. 827, 831 (2015) (arguing that when a company endorses insider trading, shareholders and non-shareholder traders assume the risk as they would in any situation where a party voluntarily accepts a known risk).

154. James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 635 (observing that "the investor is no worse off when the

his shares of Mega irrespective of Trader B's actions. It may be true that if Trader A had the inside information he would not have sold his shares, but whether the insider abstained from trading or not, the outcome for Trader A would have been the same. Like reasoning applies to the second illustration, where Trader A bought Mega shares in advance of a negative disclosure; his decision would have been the same whether Trader B traded or did not trade.

Thus, deciding whether the counterparty sustained a loss depends on one's perspective. If one focuses on the effect of disclosure versus nondisclosure of the inside information, the counterparty suffers a loss. If, on the other hand, one focuses on whether the insider traded or did not trade, the counterparty incurs no loss.[155]

Advocates of insider trading discount any injury to the counterparty because, they argue, the overall benefits of insider trading outweigh its overall harm. They point out that insider trading often results in higher share prices over time, which benefits most shareholders.[156] Similarly, non-insider buyers who purchase shares before the dissemination of the inside information benefit from insider trading once the information is publicly disclosed.[157]

Some justify insider trading by arguing that the profits from such trading are a form of executive compensation. By developing and implementing successful business strategies, corporate executives generate valuable inside information. It is fitting, some argue, that they benefit from the very information they create. Allowing executives to reap the benefit of their contributions provides them with an incentive to continue to develop innovative products and services.[158]

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insider trades than when the insider does not trade [because t]he investor's decision to sell or purchase is unaffected by whether the insider is also secretly buying or selling shares in the open market").

155. *See* William K.S. Wang, *The Importance of "The Law of Conservation of Securities": A Reply to John P. Anderson's "What's the Harm in Issuer-Licensed Insider Trading?"*, 69 U. MIAMI L. REV. 811, 812–14 (2015) (describing how counterparties to insider trading are or are not injured).

156. HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 102 (1966) ("[T]here is both a plus and a minus for outside sellers from insider trading. The plus is the higher price received by those who would have otherwise sold at the stable, lower price, and the minus is the number of sales that now occur but which otherwise would not have occurred.").

157. *Id.* at 103 ("We must add to the plus side of the equation the gain resulting to noninside buyers . . . as these individuals are benefited to the same extent as inside buyers, if they hold their shares until [the inside information is publicly disclosed].").

158. *See* Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35, 46 (1986) (noting that an "entrepreneur's

3. Confidence in the securities markets

Despite these back and forth arguments, the sounder conclusion is that the counterparty is injured and that such injury requires a robust insider trading law. A primary reason for insider trading law is to foster confidence in the securities markets.[159] A party trading on material, nonpublic information deceives the counterparty who reasonably expects securities markets to be fair and not to condone insiders exploiting informational advantages. Investors deserve evenhanded markets and laws that provide every investor with an equal chance to prosper. Like civil rights law, securities law should not guarantee equality of results, but it should guarantee equality of opportunity.[160] In the domain of securities law, this means equal access to material information. Traders who see their investments dwindle feel cheated when beset with an informational disadvantage spawned by unequal access. If the ordinary investor had access to the material information that the insider used, then the ordinary investor would have acted differently and would have benefitted from the information.

Ordinary investors feel that the system is rigged.[161] They believe that corporate insiders have an advantage that renders trading securities a game of Russian roulette. When investor distrust of the securities markets swells, their willingness to invest falters, trading volume sinks, stock prices fall, and fewer new issues come to market.[162] This integrity-of-the-markets argument presents a sound

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compensation must have a reasonable relation to the value of his contribution to give him incentive to produce more information").

159. *See generally* Spencer Derek Klein, Note, *Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence*, 16 HOFSTRA L. REV. 665 (1988) (analyzing the different variables that affect consumer confidence in the securities markets, including insider trading violations).

160. *Cf.* Griggs v. Duke Power Co., 401 U.S. 424, 430–31 (1971) (stressing that Title VII of the Civil Rights Act of 1964 strives to achieve equality of opportunity but not equality of result); Kenneth R. Davis, *Wheel of Fortune: A Critique of the "Manifest Imbalance" Requirement for Race-Conscious Affirmative Action Under Title VII*, 43 GA. L. REV. 993, 1038 (2009) (explaining that the Supreme Court interpreted Title VII to "reconcile[] equality of opportunity with meritocracy").

161. *See* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 357 (1979) (reporting that inside information harms public investors and discourages their entry into the markets, which raises the cost of acquiring capital).

162. *See* Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223, 235 (1992) (noting that "[u]nconstrained opportunism based on information asymmetry almost inevitably causes market failure," and that "[e]ven in the absence of a stock market crash, information asymmetry is likely to squeeze smaller shareholders from stock market

rationale for an approach to insider trading law that is stricter than the current regime under section 10(b).

B. The Deficiencies of the Misappropriation Theory

The same problems that plague the classical theory apply with equal, if not greater, force to the misappropriation theory. Before discussing these deficiencies, however, it is useful to examine the case that presaged the misappropriation theory: *Carpenter v. United States*.[163] In *Carpenter*, R. Foster Winans, a *Wall Street Journal* reporter partly responsible for preparing the touted "Heard on the Street" column, provided advance notice of the column to others who traded on the information.[164] Based on these unauthorized communications, Winans was charged with mail fraud and wire fraud.[165]

The Supreme Court held that the contents of the column were business property and that the use or disclosure of that information, without the permission of the *Journal*, was misappropriation of that property.[166] Winans, as an employee of the *Journal*, had a fiduciary duty not to misappropriate such information.[167] The Court rejected Winans's argument that his conduct caused no harm to the *Journal*;[168] the harm, the Court believed, was depriving the *Journal* of the exclusive use of the column.[169]

It is hard to see, however, how the *Journal* was harmed. It maintained the power to use the information any way it wished despite the misappropriation because, unlike tangible property, both the owner and the misappropriator may use the information simultaneously.

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participation when they discover that they cannot achieve normal returns in an environment of windfall profits realized by unfairly advantaged traders"); *see also* H.L. Wilgus, *Purchase of Shares of Corporation by a Director from a Shareholder*, 8 MICH. L. REV. 267, 297 (1910) (observing that when a director trades on inside information, he or she "offends the moral sense; no shareholder expects to be so treated by the director he selects; no director would urge his friends to select him for that reason; that the law yet allows him to do this, does more to discourage legitimate investment in corporate shares than almost anything else").

163. 484 U.S. 19 (1987).

164. *Id.* at 23.

165. *Id.* at 24.

166. *Id.* at 25, 28; *see also* United States v. O'Hagan, 521 U.S. 642, 654 (1997) (holding that "[a] company's confidential information . . . qualifies as property to which the company has a right of exclusive use").

167. *Carpenter*, 484 U.S. at 27–28.

168. *Id.* at 26.

169. *Id.*

As *Chiarella* and *O'Hagan* demonstrate, the Court believes that the way the trader acquired the information is critical to determining the scope of liability.[170] It is understandable why the Court has endeavored to limit the scope of insider trading liability to situations where the party trading on inside information has wrongfully acquired information. Sometimes researchers acquire information legitimately, but the limiting principle that the Supreme Court has adopted—deception on the source—is particularly misguided in misappropriation cases.[171] One problem is that the Court's limiting principle is under-inclusive.[172] For example, if the source of information encourages the tippee to trade on the information, the tippee would not have breached a duty to the source of the information by trading; hence, the tippee is not guilty of misappropriation. It makes no sense to determine liability based on whether the source permitted or forbade the tippee to trade. In both situations, the harm inflicted on the counterparty and on the public's confidence in the securities markets is the same.[173]

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170. *See supra* Sections I.A–B (describing the evolution of the classical and misappropriation theories).

171. *See* Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775, 830 (1988) (noting that misappropriation seems to have little relevance to securities fraud unless the source of the misappropriated information traded with the misappropriator); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1496 (1999) (recognizing that "*O'Hagan* worked a vast, unwitting, and wholly unwarranted expansion of Rule 10b-5 to reach deceptions of parties wholly outside of and unconnected to the securities markets").

172. The SEC has mitigated this problem to some extent by promulgating Rule 10b5-2. This rule establishes for purposes of section 10(b) liability a presumption of misappropriation under defined circumstances. Rule 10b5-2 provides that a duty of confidence exists under the following nonexclusive circumstances:

> (1) Whenever a person agrees to maintain information in confidence; (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences . . . ; or (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling . . . .

17 C.F.R. § 240.10b5-2(b)(1)–(3) (2015). No duty arises under the third category, however, if the recipient, based on the parties' history or understanding, did not reasonably believe the information was conveyed with an expectation of confidentiality. *Id.*

173. *See* Bryan S. Schultz, Note, *Feigning Fidelity to Section 10(b): Insider Trading Liability After* United States v. O'Hagan, 66 U. CIN. L. REV. 1411, 1435 (1998) (arguing that "[u]nlike the established parameters of the classical theory of insider trading liability, the misappropriation theory ignores the plight of the deceived investor").

Another inadequacy of the current approach is that it does not clearly forbid trading on stolen information.[174] The Second Circuit confronted this situation in *SEC v. Dorozhko*.[175] A trader hacked into a server and acquired the earnings report of IMS Health before the report's public release.[176] Based on this report, the hacker, Oleksandr Dorozhko, purchased IMS put options and scored a profit of more than $286,000.[177] The district court held that because Dorozhko did not breach a fiduciary duty or a duty of confidence to either IMS or Thomson Financial, the owner of the server, he did not use a "deceptive device" within the meaning of section 10(b).[178] Taking a dubiously expansive view of "deceptive device" in connection with the purchase or sale of a security, the Second Circuit disagreed, holding that misrepresenting one's identity to gain access to a server is a deception under section 10(b).[179] Regardless of the Second Circuit's analytical bootstrapping, the court reached the sensible result. Dorozhko used the inside information to gain an unfair informational advantage, thereby injuring the counterparty and potentially harming investor confidence in the securities markets.[180]

C. *The Deficiencies of the Tipper/Tippee Theory*

Justice Blackmun was correct in arguing that the majority in *Dirks* erred when it rested liability on whether the tipper gained a benefit from the trade.[181] This Article has argued that an insider's breach of fiduciary duty to the corporation, though wrongful, is wholly unconnected to any injury the insider caused by trading on inside information. Even accepting, *arguendo*, the premise that such a

174. *See* Nelson, *supra* note 136, at 2190–92 (noting that the liability of thieves for trading on inside information is unsettled and arguing that holding thieves liable under section 10(b) is a "logical extension" of existing doctrine).

175. 574 F.3d 42 (2d Cir. 2009).

176. *Id.* at 44.

177. *Id.*

178. *Id.* at 45.

179. *Id.* at 51.

180. *See id.* at 49 (characterizing the SEC's argument about Dorozhko's misrepresentation as a "straightforward theory of fraud"); Mark F. DiGiovanni, Note, *Weeding out a New Theory of Insider Trading Liability and Cultivating an Heirloom Variety: A Proposed Response to* SEC v. Dorozhko, 19 GEO. MASON L. REV. 593, 596–97 (2012) (arguing that a "constructive breach" theory correctly places *Dorozhko* within the Supreme Court's analytical framework because the theory creates a fiduciary duty on the part of one who wrongfully obtains property from another).

181. Dirks v. SEC, 463 U.S. 646, 671–73 (1983) (Blackmun, J., dissenting) ("The fact that the insider himself does not benefit from the breach does not eradicate the shareholder's injury.").

breach of confidentiality should be a pre-requisite to liability, the additional requirement that the insider derive a benefit from the trade adds yet another level of dysfunction to an already muddled framework. If someone aids and abets a robbery, for example, his guilt does not turn on whether he received some of the booty. In no other context does a breach of fiduciary duty hinge on whether the fiduciary derived a benefit from his wrongdoing. Breaches of the duty of loyalty, care, and good faith depend on the conduct of the fiduciary rather than on whether the breach was profitable.[182] For example, if the CEO of Corporation A is secretly serving as CEO for rival Corporation B, it is not a defense that he was serving as CEO of Corporation B free of charge.

As demonstrated, the law of insider trading condones various cases of knowingly trading on inside information. Current law imposes objectionable liability requirements: there must be a breach of a fiduciary duty or confidentiality to the source, and, in tipper/tippee cases, the tipper must gain a benefit. This Article proposes that the *Cady, Roberts* fraud-on-the-market theory could rectify the conceptual anomalies that plague the current framework.[183]

III. THE *CADY, ROBERTS* DUTY AND FRAUD-ON-THE-MARKET THEORY

The question remains how to redirect the focus of insider trading law away from a breach of fiduciary duty to the source and toward a breach of duty to the counterparty. One obstacle to this refocusing is the lack of a direct interaction between parties trading in impersonal, computerized markets.

A. The Affiliated Ute Citizens *Presumption of Reliance*

The Court's reasoning in *Affiliated Ute Citizens v. United States* provides a possible solution to this problem by creating a presumption of reliance in omission cases.[184] In that case, members of the Ute tribe owned shares of Ute Distribution Corp. ("UDC"), a

182. *See, e.g.*, McMullin v. Beran, 765 A.2d 910, 921–23, 925–26 (Del. 2000) (reinstating shareholders' claims against directors for breach of fiduciary duties of loyalty, care, and good faith for failure to maximize shareholder value in recommending sale of chemical corporation); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 351 (Del. 1993) (remanding a case to the trial court where the plaintiff argued that the directors breached the duties of loyalty and care by approving a cash-out merger), *modified on reargument*, 636 A.2d 956 (Del. 1994).

183. *See infra* Part III.

184. 406 U.S. 128, 153 (1972).

company with oil, gas, and mineral rights.[185] First Security Bank of Utah was the transfer agent of UDC.[186] Two assistant managers of the bank purchased UDC shares from tribe members at depressed prices, failing to disclose the market price.[187] The issue was whether the plaintiffs failed to meet the reliance element of section 10(b), and Rule 10b-5 thereunder, because the fraud was based on omissions, not affirmative misrepresentations.[188]

The Tenth Circuit held that someone cannot rely on an omission because one cannot rely on what a party failed to disclose.[189] The Supreme Court reversed, holding that, in a material omission case, section 10(b) did not require affirmative proof of reliance.[190] To infer reliance, a court had to find that a reasonable investor might have considered the undisclosed information important in making an investment decision.[191] Because the market price of the stock would have been important to someone deciding whether to sell it, the two assistant bank managers in *Affiliated Ute Citizens* had a duty to disclose the market price of the stock to the Ute tribe members who sold stock to them.[192]

There is, however, a potential objection to applying the *Affiliated Ute Citizens* reliance presumption to insider trading cases: because the parties to trades do not deal directly with each other, it would seem unreasonable to require the insider to make disclosures to an unidentified counterparty. Failing to make such disclosures would therefore not reasonably seem to constitute a breach of duty. If, on the other hand, the presumption of reliance attaches automatically to every market participant, one might question whether such a presumption is justified where a market is inefficient. Such a market might not absorb and take account of material information. The disclosure would therefore never have reached the counterparty. To meet this objection, one might propose an approach more tenable than the *Affiliated Ute Citizens* presumption of reliance. This approach, which considers

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185. *Id.* at 136.
186. *Id.* at 145.
187. *Id.* at 146–47.
188. *Id.* at 152.
189. *Id.*
190. *Id.* at 153.
191. *Id.* at 153–54.
192. *Id.* at 153. Judge Spatt followed this approach in *In re Sterling Foster & Co.*, 222 F. Supp. 2d 216 (E.D.N.Y. 2002), a class action suit alleging unlawful insider trading based on material omissions. *Id.* at 275 (stating that "[b]ecause the complaint is based on the defendants' failure to disclose material facts, reliance is presumed").

market efficiency, is fraud-on-the-market theory based on the *Cady, Roberts* duty to disclose material, nonpublic information.[193]

B. The Cady, Roberts *Duty to Disclose or Abstain*

In re Cady, Roberts & Co. was an administrative proceeding in which the SEC charged Robert Gintel, a partner of a broker-dealer firm, with unlawful insider trading.[194] Gintel had learned of a cut in the dividends of Curtis-Wright, a company traded on the NYSE.[195] Based on this nonpublic information, Gintel exercised his discretionary authority to sell his clients' Curtis-Wright stock.[196] The SEC found that Gintel had violated section 10(b) and Rule 10b-5.[197] In so holding, the SEC issued a pronouncement that has shaped securities law:

> We[] and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.[198]

This requirement—either to publicly disclose material information or abstain from trading—is the duty on which to base insider trading law. When people trade a security based on inside information, they breach the *Cady, Roberts* duty of disclosure. Such a material omission is a deception that violates section 10(b).[199]

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193. *See infra* Section III.B–C; *see also supra* text accompanying note 21 (suggesting that fraud-on-the-market theory might be applied to insider trading cases).
194. 40 S.E.C. 907, 908 (1961).
195. *Id.* at 909.
196. *Id.*
197. *Id.* at 911, 917–18. The SEC found that Gintel's wrongful conduct was willful. *Id.* at 917. As a mitigating factor, the SEC also found that the leak of the information to Gintel was not planned. Therefore, in addition to the $3,000 fine imposed by the NYSE, the SEC suspended Gintel from the NYSE for only twenty days. *Id.* Commissioner Frear found the suspension insufficient. *Id.* at 918.
198. *Id.* at 911 (footnote omitted).
199. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 152–53 (1972) (holding that Rule 10(b) may be violated absent a material misrepresentation of fact).

C. Fraud-on-the-Market Theory

The Supreme Court established fraud-on-the-market theory in *Basic Inc. v. Levinson.*[200] Beginning in 1976, Basic engaged in merger talks with Combustion Engineering, but Basic issued three public statements denying these merger negotiations.[201] When Basic announced a tender offer from Combustion Engineering in December of 1978, Basic's stock rose.[202] Former Basic shareholders who had sold their shares before Basic announced the tender offer sued under section 10(b), alleging that they sold at depressed prices.[203] The issue was whether, in this class action, the law could presume that the plaintiffs relied on the three public statements denying merger negotiations.[204] Adopting fraud-on-the-market-theory, the Court established a rebuttable presumption of reliance.[205] To explain the presumption, the Court quoted *Peil v. Speiser*[206]:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.[207]

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200. 485 U.S. 224, 245 (1988). For a further discussion of fraud-on-the-market case law, see *infra* notes 217–28 and accompanying text (discussing Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2416–17 (2014)).

201. *Basic*, 485 U.S. at 227; *see also id.* at 241–42 (discussing factors to help delineate when a market is efficient or, in the words of *Basic*, "open and developed," and explaining that such markets are entitled to the presumption raised by fraud-on-the-market theory); Cammer v. Bloom, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989) (articulating five factors to help determine the applicability of fraud-on-the-market theory: (1) high average trading volume of the security in question (a volume of two percent of the public float would justify a strong presumption of market efficiency); (2) the number of securities analysts following the security in question; (3) the number of markets on which the security in question trades; (4) the entitlement of the company in question to file an S-3 Registration Statement with the SEC; and (5) the immediacy of a reaction in the price of the security in question to unexpected corporate events or informational releases).

202. *Basic*, 485 U.S. at 228.

203. *Id.*

204. *Id.* at 242.

205. *Id.*

206. 806 F.2d 1154 (3d Cir. 1986).

207. *Basic*, 485 U.S. at 241–42 (quoting *Peil*, 806 F.2d at 1160–61).

The presumption is not absolute. It applies only when a market is well-developed and therefore efficient in disseminating information.[208] Such efficiency assures that the information will affect the price of the security in question.[209] As the Court observed, "Recent empirical studies have tended to confirm Congress's premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."[210] The Court pointed out that the defendants might have rebutted this presumption in several ways.[211] For example, if the defendants could have proven that the market makers knew about the merger talks, their knowledge would have corrected any distortion of the stock price in the marketplace.[212] Similarly, a below-fair-value market price would have been eliminated if news of the merger negotiations had filtered into the marketplace.[213] A third example would be if the plaintiffs should have known of the merger negotiations but sold anyway for other reasons such as potential antitrust concerns or political pressure.[214]

Although *Basic* was a material misrepresentation case, the rebuttable presumption of fraud-on-the-market theory also applies to material omission cases.[215] Insider trading cases involve material omissions; thus, the party trading on inside information has a *Cady, Roberts* duty to publicly disclose the inside information.[216] A failure to meet this duty in an efficient market affects every party who owns or trades the relevant security.

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208. *Id.* at 247.
209. *Id.*
210. *Id.* at 246.
211. *Id.* at 248.
212. *Id.*
213. *Id.* at 249.
214. *Id.*
215. *See, e.g.*, Binder v. Gillespie, 184 F.3d 1059, 1064 (9th Cir. 1999) (noting that "the presumption of reliance is available only when a plaintiff alleges that a defendant made material representations or omissions concerning a security that is actively traded in an 'efficient market,' thereby establishing a 'fraud on the market'"); Freeman v. Laventhol & Horwath, 915 F.2d 193, 197 (6th Cir. 1990) (stating that "[o]ne of the circumstances justifying a presumption of reliance arises when a plaintiff alleges that a defendant made material representations or omissions concerning a security that is actively traded on an efficient market, thereby establishing a fraud on the market"); *In re* Sterling Foster & Co., 222 F. Supp. 2d 216, 274–75 (E.D.N.Y. 2002) (recognizing the applicability of fraud-on-the-market theory to a case involving both material misrepresentations and omissions).
216. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

The Supreme Court in *Halliburton Co. v. Erica P. John Fund, Inc.*[217] reaffirmed and elaborated fraud-on-the-market theory.[218] The *Halliburton* Court addressed two principal arguments. First, Halliburton questioned the *Basic* Court's premise of the efficient dissemination of information in securities markets.[219] Halliburton argued that recent empirical evidence showed that some publicly disclosed information is not absorbed immediately into the markets.[220] The Court dispensed with this argument, noting that under fraud-on-the-market theory, the presumption of reliance is rebuttable.[221] If a defendant proves that publicly disclosed information did not reach or affect investors, the party would rebut the presumption of reliance.[222] The second argument questioned whether most investors rely on the integrity of the market.[223] Halliburton cited so-called value investors, day traders, and volatility arbitragers as examples of investors who are largely indifferent to market information.[224] For example, day traders, who seek out and buy undervalued stocks, concentrate on long-term upward trends they perceive in the prices of securities rather than on passing

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217. 134 S. Ct. 2398 (2014).

218. *Id.* at 2417.

219. *Id.* at 2409. The Supreme Court pointed out that *Basic* never characterized market efficiency as binary. *Id.* Because the Court recognized that market efficiency is imperfect, it made the presumption of reliance rebuttable and subject to the evidence bearing on the circumstances raised in any particular litigation. *Id.* at 2410. *See* Baruch Lev and Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 20 (1994) (arguing that capital markets are not fundamentally efficient and, though noting significant exceptions, stating that fundamental market information is not the primary influence on the price of an individual stock or the market in general); *see also* Roberta S. Karmel, *When Should Investor Reliance Be Presumed in Securities Class Actions?*, 63 BUS. LAW. 25, 54 (2007) (arguing that a wholesale repudiation of fraud-on-the-market theory would weaken the effectiveness of the SEC's integrated disclosure system and impair the viability of worthy class actions). *But see* Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 167–68 (characterizing the application of fraud-on-the-market theory as a "judicial muddle" and arguing that because market efficiency is not a binary, yes-or-no question, one cannot sensibly argue in every case that material information affects market prices).

220. *Halliburton*, 134 S. Ct. at 2409.

221. *Id.* at 2410.

222. *Id.* at 2410–11.

223. *Id.*

224. *Id.*

information.[225] The Court answered this argument by noting again that the *Basic* presumption is rebuttable, stressing that *Basic* merely presumed the reliance of most, but not all, investors.[226] The Court also questioned whether any investors, including value investors, are indifferent to the integrity of market prices.[227] Such investors ultimately rely on all available material information.[228]

Applying fraud-on-the-market theory to the *Cady, Roberts* duty to disclose would resolve the conceptual deficiencies of current insider trading law. This new theory of unlawful insider trading would eliminate the requirement of establishing a breach of fiduciary duty or confidentiality on the source of the information. A fraud-on-the-market theory of insider trading would also do away with the *Dirks* requirement that the tipper receive a benefit from the trade.[229] The efficacy of fraud-on-the-market theory, however, is limited to instances where the security in question trades on an efficient market. Although most cases involve securities traded on efficient markets, such as the NYSE or the NASDAQ, congressional enactment of a law dedicated to insider trading would present an even more comprehensive means for revamping insider trading law.

IV. LEGISLATIVE APPROACHES TO IMPROVE INSIDER TRADING LAW

Congress should enact a new provision that, unlike section 10(b), is dedicated specifically to insider trading. Three legislative proposals are pending before Congress.

A. *Pending Legislation*

Congressman Stephen Lynch,[230] Congressman James Himes,[231] and Senators Jack Reed and Robert Menendez[232] have each proposed legislation. All three will be discussed below.

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225. *See id.* at 2410 (explaining that while false, passing statements affect the price of a stock, market professionals focus on the "material statements about companies," which affect the whole market).

226. *Id.* at 2411.

227. *Id.*

228. *See id.* (explaining that a stock's market price eventually reflects material information).

229. *See* Dirks v. SEC, 463 U.S. 646, 666 (1983) (finding no violation of the *Cady, Roberts* duty where employees did not obtain monetary or personal benefit for revealing secrets).

230. Ban Insider Trading Act of 2015, H.R. 1173, 114th Cong. (2015).

231. Insider Trading Prohibition Act, H.R. 1625, 114th Cong. (2015).

232. Stop Illegal Insider Trading Act, S. 702, 114th Cong. (2015).

1. The Lynch bill

This bill would make it unlawful "[t]o purchase or sell any security, . . . based on information that the person knows or . . . should know is material information and inside information."[233] An improvement on current insider trading law, this bill would eliminate the requirement that the tipper receive a benefit from the tippee.[234] This proposal, however, is problematic because it retains the conceptual flaw of classical theory and misappropriation theory by defining inside information as information that is obtained "directly or indirectly from an issuer with an expectation of confidentiality or that such information will only be used for a legitimate business purposes [sic]; or in violation of a fiduciary duty."[235]

2. The Himes bill

Broader in the scope of its prohibitions than the Lynch bill, the Himes bill would make it unlawful to purchase or sell a security while in possession of material, nonpublic information if the person knows or recklessly disregards that such information was obtained by theft, bribery, misrepresentation, espionage, deception, or a breach of fiduciary duty or confidence.[236] This proposal would thus retain the classical and misappropriation theories while expanding the list of prohibited means for acquiring the inside information.[237] This law would make it unlawful to communicate material, nonpublic information to another person if it was reasonably foreseeable that the other person would purchase or sell the security using the information or provide the information to a third party who might foreseeably purchase or sell the security.[238] A person who knew or recklessly disregarded that such information was wrongfully obtained or communicated has committed a violation even if the person did not know the means through which the information was obtained or whether the tipper received a personal benefit.[239]

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233. H.R. 1173 § 2.
234. *Id.*
235. *Id.*
236. H.R. 1625 § 2.
237. *See id.* (broadening the list of prohibited means to include "theft, bribery, misrepresentation, or espionage").
238. *Id.*
239. *Id.*

3. The Reed-Menendez bill

The best of the three proposals, a bill sponsored by Senators Jack Reed and Robert Menendez, would impose an even broader insider trading ban than the Lynch and Himes bills. This bill would make it unlawful "[t]o purchase, sell, or cause the purchase or sale of any security on the basis of material information that that the person knows or has reason to know is not publicly available."[240] Because the Reed-Menendez bill does not catalogue unlawful means of acquiring inside information, it is preferable to the Himes bill. All that the Reed-Menendez bill requires is that the information be material and nonpublic.[241] Like the Lynch and Himes bills, the Reed-Menendez bill would impose a broad scope of tipper/tippee liability by making it unlawful "[t]o knowingly or recklessly communicate material information that the person knows or has reason to know is not publicly available to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in [liability for insider trading]."[242] The *Dirks* benefit requirements would thus be discarded. This bill protects trading based on bona fide research by exempting from liability a person who trades on "information that the person has independently developed from publicly available sources."[243]

B. A Proposed Revision of the Reed-Menendez Bill

The Reed-Menendez bill, though vastly superior to the present law of insider trading, might be improved. As noted, the bill makes it unlawful to knowingly or recklessly communicate material information when it is reasonably foreseeable that the recipient will trade on the information.[244] This prohibition of insider trading unnecessarily limits potential liability in two ways. First, the requirement that the source of the information "knowingly or recklessly" communicates the information should be deleted because recklessness is an unnecessarily ambiguous standard. *SEC v. Switzer*[245] illustrates the problematic nature of this standard.

In *Switzer*, Barry Switzer, the well-known head coach of the University of Oklahoma football team, attended a track meet

240. Stop Illegal Insider Trading Act, S. 702, 114th Cong. § 2 (2015).
241. *Id.*
242. *Id.*
243. *Id.*
244. *Id.*
245. 590 F. Supp. 756 (W.D. Okla. 1984).

conducted at the university's field.[246] George Platt, who also attended the meet, was a director of Phoenix Resources and the CEO of Texas International, which had acquired Phoenix Resources.[247] Though Switzer and Platt knew each other and greeted each other at the event, neither knew that the other planned to attend, and they did not sit together.[248] While in the stands, Switzer overheard Platt tell his wife that Phoenix might be liquidated.[249] Switzer passed this information to several of his friends, and he and his friends traded Phoenix shares and profited from the transactions.[250]

The district court found that Platt had unintentionally passed this inside information to Switzer, and therefore neither he nor Switzer violated section 10(b).[251] It would seem reasonable, however, to find that Platt violated the section by acting recklessly. One might question why this nebulous standard should be incorporated into a new insider trading law.[252]

One might go a step further: In civil cases, the mental state of the person communicating the information to another person should not matter in determining whether a violation has occurred.[253] The mere communication of the insider information, regardless of the circumstances, should be enough to impose liability on the insider. The law should impose on insiders a duty to protect the confidentiality of material, nonpublic information. Whether acting

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246. *Id.* at 761.

247. *Id.* at 758–60.

248. *Id.* at 761.

249. *Id.* at 762.

250. *Id.* at 762–63.

251. *Id.* at 762, 766.

252. The federal circuit courts have uniformly accepted a showing of recklessness to meet the scienter requirement of a section 10(b) violation. *See e.g.*, *In re* Ikon Office Sols., Inc., 277 F.3d 658, 667 (3d Cir. 2002) (noting that to meet the scienter element of section 10(b), a plaintiff must show highly unreasonable conduct exceeding mere negligence); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569–70 (9th Cir. 1990) (citing Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044–45 (7th Cir. 1977)) (holding that an extreme departure from ordinary care constitutes recklessness). There would be, however, no inconsistency in rejecting recklessness as the standard of liability for communicating inside information to a third party. In an ordinary securities fraud case, the recklessness standard applies to the deceptive conduct, whereas—in an insider trading case—communicating insider information is not the deceptive conduct. *See* Robert H. Rosenblum, *An Issuer's Duty Under Rule 10b-5 to Correct and Update Materially Misleading Statements*, 40 CATH. U. L. REV. 289, 293, 300 (1991) (explaining that failure to disclose the inside information to the counterparty constitutes the fraudulent omission).

253. In criminal cases, a higher standard of mens rea would be necessary to support a conviction.

with intent, recklessness, negligence, or even without fault, the person communicating the information has failed to meet that duty and has tacitly, if not actively, encouraged the recipient of the information to use it for profit. Such a use undermines investor trust in the integrity of the securities markets.[254] A decline in investor trust could result in the curtailment of trading activity and initial and secondary public offerings.[255] The current regime established in *Chiarella*, *O'Hagan*, and *Dirks* has already threatened investor confidence. A new law should, in civil cases, impose strict liability on those who provide material, nonpublic information and those who trade on that information. The one exception should cover instances where the information was acquired though legitimate research.

The Reed-Menendez bill makes the communication of inside information unlawful only "under circumstances in which it is reasonably foreseeable that such communication is likely to result in a" prohibited insider trade.[256] This qualification on liability should also be deleted. Any time that a tipper communicates material, nonpublic information to a third party, it follows that the third party is reasonably likely to trade on that information. Yet, the bill implies that the DOJ, SEC, or individual plaintiff must prove something more than this apparent inference. Such proof might, for example, be the recipient's statement indicating an intention to trade. Requiring such a statement, however, would put a nonsensical pre-condition on liability. Tippers and tippees are sophisticated, and they quickly catch on to the rules of the game. The law should not coach the tippee to solemnly disavow to the tipper the intent to trade, thereby exonerating the tipper.

If both of the changes suggested in this Article were adopted, the relevant subsection would provide as follows: It is unlawful to communicate nonpublic material information to any person who trades on the basis of the communicated information, if the person communicating the information knows or has reason to know that the communicated information is not publicly available.[257]

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254. *See supra* Section II.A.3.
255. *Id.*
256. Stop Illegal Insider Trading Act, S. 702, 114th Cong. § 2 (2015).
257. This provision would impose a general restriction on insider trading similar in scope to the ban prescribed in Rule 14e-3 for trading on inside information relating to tender offers. Rule 14e-3(a) provides that

> If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the 'offering person'), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of

CONCLUSION

It is astonishing that federal law lacks a specific insider trading prohibition. Congress has ceded its responsibility to the Supreme Court, which has strained the language of section 10(b) to fashion a federal common law of insider trading.[258] Unfortunately, it is not sound law. The Supreme Court has revealed its bias disfavoring a broad prohibition of insider trading. It has touted the benefits of a framework that gives wide latitude to "market research," even when certain "research" methods seem suspect, if not blatantly wrongful. The current regime must be overhauled, if not abandoned. Under present law, if someone in a restaurant overhears Tim Cook tell a colleague that Apple will soon announce blowout earnings, the eavesdropper may trade on the information with impunity. It is unclear under current law whether someone has violated section 10(b) by breaking into the offices of a corporation, discovering evidence of flagging sales, and selling the company's stock short. If an ex-director of a company tips off an acquaintance that the Department of Justice is investigating the company for falsifying its balance sheet in a 10K filing, the tippee may trade the stock even if the investigation is undisclosed to the public. One must wonder how this can be so.

Many people feel that the "system" is rigged. This sense of futility rages in the public mind over income inequality, Washington politics, and Wall Street financial shenanigans. Unprecedented dissatisfaction with the 2016 presidential candidates, underlines the public's frustration, malaise, and anger.[259] This Article does not presume to

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> section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly [from the offering person, the issuer, or anyone acting on their behalf].

17 C.F.R. § 240.14e-3(a) (2015); *see also* Council Directive 2003/6, arts. 1–4, 2003 O.J. (L 96) 20–21 (EC) (broadly banning trading on inside information in the European Union without limiting liability to breaches of confidentiality or the tipper's acquisition of benefits).

258. *See* Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 935 (2014) (referring to the development of insider trading law as a "common-law-like elaboration").

259. *See* Brian Naylor, *This Election, Anger and Frustration Aren't Just on the Right*, NPR (Jan. 22, 2016, 4:11 PM), http://www.npr.org/2016/01/22/464013725/this-election-anger-and-frustration-isnt-just-on-the-right (discussing the widespread dissatisfaction among the electorate); *Clinton Holds Lead amid Record High Dislike of Both Nominees*, MONMOUTH U. (Aug. 29, 2016), https://www.monmouth.edu/polling-

suggest how to quell public discontent. But the Article does offer a replacement for tortuous insider trading law. We need a law that will restore public confidence in at least one facet of the largely discredited financial markets. Let's give the public something to celebrate.

institute/reports/MonmouthPoll_US_082916/ (reporting a poll showing that thirty-five percent of respondents did not have a favorable view of either major presidential candidate).